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EVALUATING THE IMPACT OF OFFSHORING ON US NATIONAL SECURITY

BY

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This research paper examines the concept of offshoring by applying the Dr H. Richard Yarger's Strategic Appraisal Model. The analysis establishes the significance of offshoring as an item of national interest, reviewing its attributes and trends. The paper surveys arguments for and against offshoring, considering its merits in the context of comparative advantage theory. It then assesses information pertaining to the current environment, culminating in a discussion of the significant strategic factors and inferred impacts to the instruments of national power. Finally, the paper offers recommendations for a national strategy for offshoring.

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EVALUATING THE IMPACT OF OFFSHORING ON US NATIONAL SECURITY

The term "offshoring" refers to the practice of a domestic company to employ the services of foreign workers located in foreign countries to fulfill some portion of the company's labor requirements. The practice connotes talent redistribution amid the broader socio-economic proclivity toward globalization. Offshoring is controversial because it anecdotally affects domestic employment and relocates intellectual capital. In 2004, approximately 70% of Americans believed that outsourcing jobs overseas actually does more to hurt than to help the US economy.[1] Two years later, still more than half of Americans were generally skeptical of any effort to increase free trade between the US and foreign markets, feeling that the US more often emerges short-handed.[2] While offshoring may, in fact, deplete or dilute certain technical competencies in America, this research concludes that the practice does not necessarily present a significant threat to national security because it promotes international cooperation.

This paper explores the current environment and projected implications of offshoring from the "strategist's weltanschuung" point of view, using Dr. H.R. Yarger's Strategic Appraisal Process[3] (SAP) as a guide. The SAP model begins by surveying existing knowledge of the underlying topic and linking its strategic factors to elements of national strategic interest. The model concludes by articulating an appropriate strategy toward the topic, forming the basis for policy in terms of ends, ways, and means.

Stimulus for a Strategy on Offshoring

Initiating an assessment of offshoring requires an appreciation for the appropriate realm of strategy, in terms of level and kind.[4] Offshoring provides a mechanism for delivering opportunity to trading partners, while exposing a corresponding threat to the participants' resources. This offsetting relationship, with its potential for mutual micro- and macro-economic benefit and its definitive restructuring of the national labor pool, establishes offshoring as a business practice that deserves strategic attention at the point-of-transaction, national, and global levels, and within the realms of economic and security policy.

The rationale to pursue or not to pursue offshoring rests within four primary perspectives. First, at the firm-level, labor offshoring represents a viable option for managing corporate income statements and enriching talent pools.[5] The practice is notionally similar to trading in any other commodity, as corporate executives seek to minimize production costs by purchasing components at relatively low rates. Companies who outsourced in 2005 generally saved in overall production costs, with research and development functions enjoying an average cost reduction of 59% and information technology an average of 39%.[6] Additionally, more recent studies indicate that an increasing number of companies transcend beyond the cost consideration, citing their quest for exceptionally qualified talent as a primary motivator for labor offshoring.[7]

A second perspective emanates from the industry-level, as firms collectively respond to competitive pressures which raise the expectations for productivity and innovation. While offshoring practices during the 1960's generally focused on assembly of products abroad, the trend proceeded through the 1980's with an emphasis on physically relocating manufacturing facilities. During the early 2000's the practice of offshoring has added a tendency toward project design activities, increasing its applicability to more inventive endeavors.[8] The US semiconductor industry, one having substantial military systems relevance, began its offshoring practices in the 1960's, while the software industry initiated the practice in the 1990's.[9] US companies within the technology infrastructure sector offshored approximately $17 billion in projects in 2009, with some analysts anticipating 21% annual growth until at least 2012.[10] Other sectors fielding significant offshoring relationships with foreign providers include administrative business processes, customer call centers, and procurement.[11]

The third perspective is at the national-level, where domestic strategic policy considers the broader impacts stemming from shifts in tax bases and recalibrations of gross domestic labor requirements. Tax policy, for example, must account for the advent of foreign earned income and disparate methods for valuing assets. Immigration policy must consider systemic stresses on boarders, as corporations seek cheap labor and as displaced skilled workers avoid menial jobs. Welfare programs must confront the onslaught of displaced workers who refuse to work under new conditions. New US education programs must stand ready to respond to shifts in domestic labor demands if the Nation is to recognize an ability to internally satisfy requirements for critical innovation skills. Abroad, many countries have facilitated offshoring by implementing official policies to promote the advancement of technical and vocational education that supports the semiconductor industry, in particular. In 2000, China embarked on a 15-year strategic plan to aggressively promote advanced education and to energize its attractiveness as a provider of world-class technology services.[12] In addition to strategic adjustments to education programs, India has significantly lowered regulatory barriers to entry for US offshoring partners to expand into its technology and business parks.[13] Further, as US governmental budgets continue to be restrictive in the next several years, the likelihood for increased reliance on offshoring to resource public projects will remain high.[14]

The fourth perspective is the global-level, where labor-providing countries emerge into new leadership roles and the benefits of comparative advantage generate newfound wealth. These tectonic shifts, while theoretically raising the collective standard of living, create regional vulnerabilities and conflicts as countries develop at different rates. Globalization exposes the opportunities for collective growth, as well as the potential for ideological conflict. For example, in the software services industry the US enjoys a position of strength as the largest global supplier, job provider, and marketplace.[15] However, as emerging countries gain significance in the field, the US may lose a degree of its technical credibility and capability to countries with significantly different ideological underpinnings and political intentions.

When employing the skills of foreign workers, companies may choose between a “captive” and an “outsourced” model, each having unique implications to the initiating country. In the former, the company actually owns and operates the offshore activity, while in the latter it hires a third party foreign company. Although the two practices are intrinsically identical as far as the services rendered, they differ in that the “captive” approach is typically met with less internal resistance from home country employees and may offer some protection to intellectual property.[16]

There are a few legislative actions that provide some degree of control over the implementation of offshoring. Antitrust Laws establish guidelines for mergers and acquisitions, which may inhibit the formation of an unfair international joint venture or multinational corporation. Domestic Source Laws, such as the “Buy American Act”, encourage public endeavors to seek internal fulfillment, rather than hiring resources from external countries. Several Import/Export Laws establish limits to size and type of foreign transactions. For example, the Arms Export Control Act and the International Traffic in Arms Regulations define permissive and restrictive parameters around certain military-related exchanges in an effort to sustain national security. A GAO report indicated in 2000 that Federal trade policies prevented a UK-owned U.S. company from obtaining a $123 million Department of Defense contract.[17] The report also found cases, however, that reveal the ineffectiveness of current legislation, allowing discreet foreign corporate acquisitions of US firms and displacements of American jobs that produce critical defense-related products.[18]

Nevertheless, offshoring operates chaotically, as the practice is generally free of significant strategic oversight. Rationale for offshoring rests within all levels of economic consideration, at the tactical, national, and global levels, inspired primarily by the traditional national value to promote free trade. In spite of the issue's sensitivity, presidential documents and congressional studies provide little commentary on national policy toward offshoring. In his National Economic Strategy (NES-2009), President Obama acknowledges that globalization stimulates innovation and innovation induces job shifts, but does not directly remark on the effects of offshoring.[19] The President's National Security Strategy (NSS-2010) currently offers no clear linkages to the practice of offshoring.[20] The impending risk of creating an imbalance between economic gain and loss of innovative talent, however, provides ample justification for offshoring as an issue worthy of national interest and a national strategy.

Survey of National Interests Associated with Offshoring

In accordance with Yarger's model, assessments of strategic issues require an articulation of their relationships to national interests.[21] Enduring US interests consist of democracy, prosperity, security, and global stability.[22] Offshoring is not directly relevant to the spread of democracy, the method of governing according to preferences of the majority. It aligns as a concept relevant to prosperity, however, as it seeks to optimize the economic benefit among the US and its trading partners. The practice of offshoring, insofar as it is a bilateral commodity trade transaction, mollifies the "persistent" national economic interest of free trade.[23] Offshoring also aligns with the national security interest, as it introduces new intellectual dependencies on entities outside the immediate control of the US. Offshoring finds a link with globalization and overall stability, as it empowers market participants, alienates nonparticipants, and potentially shuffles the relative worth of countries and multinational corporations within a given region.[24]

Intensity of National Interests Associated with Offshoring

Attaching an intensity score to the relevant national interests requires a mix of objective and subjective reasoning, which together build a case for relative criticality and prioritization. Yarger's appraisal model endorses the Nuechterlein understanding of intensity, whereby narrowly defined interests offer more clarity for assessment and typically overlap multiple broadly-defined interest categories.[25] In this context, offshoring fits well as a worthwhile focus of discussion; it represents a precise and meaningful trade issue that spans in varying degrees across the "core" interest categories of Economic Prosperity, Homeland Defense, Favorable World Order, and Promotion of Values.[26]

As with any other national interest, offshoring exists somewhere along a spectrum that conventionally consists of “Survival”, “Vital”, “Important”, and “Peripheral” degrees of intensity. Offshoring does not evoke immediate dangers sufficient to register as “Survival” or “Vital”, but may still earn consideration as an “Important” or “Peripheral” interest. The slant favors “Important”, in fact, when one considers that the beneficiary countries are places like India, China, and Russia, each having emerging economies, growing populations and political influence, and an increasingly competitive stake in claims to the world’s limited resources. Mismanaging offshore relationships in these countries may cause damages that could eventually generate significant impact to US core interests. These are precisely the countries that President Obama indicated in his NSS-2010 to be “key centers of influence” and significant target objects of US strategic partnership efforts.[27] Further, because offshoring offers mutual economic benefits and a mechanism for securing cooperative relationships, it may have measurable value and long term implications on international order. Because offshoring also relocates a certain portion of the Nation’s innovative and militarily significant labor force to foreign countries, however, it arguably threatens national security by reducing the country’s supply of internally available contributors to weapons development.

Assessment of Information Pertaining to Offshoring

To build confidence in understanding the issue under discussion, Yarger’s SAP requires a holistic analysis of all available information associated with the strategic environment, such as related facts, assumptions, trends, or attributes.[28] Unfortunately for the researcher, the Bureau of Labor Statistics does not currently provide data to define the size and trends of offshoring, and corporations do not generally share details of their offshoring practices.[29] Much of the available information pertaining to offshoring and its environment stems from experiential intuition and business inference, causing the Institute for International Economics to caution researchers from vesting excessively into definitive conclusions.[30] Nevertheless, the analytical framework, to review the scant information available, defines the offshoring strategic environment in terms of partisan politics, economic theory, sector participation in global markets, and a slate of compelling disadvantages and advantages.

Offshoring presents itself as a divisive partisan topic, commonly taking root as a topic of debate during the country's political cycle. The number of scholarly articles addressing the topic began to crescendo in the 2004 presidential election year, as measured by the number of relevant publications contained in the US Army War College Library. Some populist authors and journalists at that time condemned non-tariffed trade as a threat to national identity and real power[31]. Senator Kerry (D) featured the topic in his campaign from a protectionist point of view, referring to "Benedict Arnold" corporations that send America's jobs overseas.[32] To be sure, the country's unemployment rate had been trending upward, from roughly 8.5% in 2000 to over 10% in 2004[33], causing broad sensitivity to the practice of offshoring. New Jersey, for its part, passed legislation in 2005 to outlaw offshoring in fulfilling state government contracts altogether.[34] With unemployment in 2011 above 9%, and with little or no projection for improvement[35], the topic will likely re-energize as a partisan political issue in the 2012 race. "Outsourcing is always a hot button issue around elections, particularly when unemployment is high," according to Robert Blake, Assistant Secretary of State for South and Central Asia, who oversees US business investment practices in one of the leading regions supplying outsourced technical services.[36]

President Bush generally embraced the practice of offshoring from the Ricardian logic of comparative advantage, insisting that it offers a "win-win" situation.[37] The argument requires an assumption that any two countries are able to produce any two disparate goods at relatively different opportunity costs, with all other factors being equal. For example, Country-A may produce guns more cheaply, in terms of butter, than Country-B. Country-B, in this logic, would therefore produce butter more cheaply, in terms of guns. If each country produces only the good or service that it can produce with the least opportunity cost, and if the two countries share their products freely, the mathematical result is an enhanced benefit to both participants. The scenario offers a compelling and logical basis for free trade and specialization.[38]

While the practice of offshoring may make economic sense at the company or industry level, it is somewhat less clear as to its economic value at the strategic level. Some analysts warn against simplistic conclusions drawn from the binary transaction scenario of comparative advantage. The comparative advantage principle, for example, does not take into consideration the realities of diverse economies and political indifferences between the trading countries. Opposing political motivations and relative levels of rationality, for example, may suggest a disingenuous bias in the course of the transaction. The gun-butter scenario might operate reasonably well with the US and Canada, for instance, but would have entirely different implications with the US and North Korea. Furthermore, the interdependence stemming from an offshoring relationship, to the extent that it is borne in the most genuine of circumstances, incurs a necessary reliance and obligatory posture that may ultimately contribute to instability or dysfunction in the long run.[39] These counterarguments raise doubts as to the true net strategic value of offshoring.

Many companies outsource jobs to foreign labor in the services sectors. Highly structured and standardized jobs, such as telemarketing and accounting, are generally more exportable than jobs requiring significant doses of judgment.[40] However, bolstered by the proliferation of internet access around the world, offshoring in the fields of science and other innovation oriented jobs has become quite common. This tendency is troublesome from a military capabilities standpoint, as the technology service sector generates many of the innovations that ensure competitiveness. During the period from 2000 to 2004, the Economic Policy Institute estimated that the US lost more than 128,000 technology jobs, while India gained about 100,000.[41] While this offset is no doubt the net result of numerous factors, offshoring may explain at least a portion of the discrepancy.

An argument that positions offshoring as a practice specifically destructive to national security is the notion that it erodes away intellectual capital from the US. "Brain Drain" was a concern in 2008 when US weapons laboratories laid off significant numbers of scientists and engineers as a cost-cutting measure.[42] Whether the displaced workers would opt for foreign employment, or whether the domestic firms would replace them with cheaper skilled labor from foreign countries, the resulting situation equated to a potential degradation of the technical sector's capacity to develop weapons capability within the borders of the US. On another occasion, an engineer spokesman from the Lawrence Livermore National Laboratory indicated that national security is ultimately in jeopardy because the displacement of scientific jobs weakens "the ability of the lab to do the things we're asked to do."[43] To remain competitive, many domestic companies have found that they must reach outside the US to access sufficient quantities of innovative employees. Affordable engineers and scientists are in low supply and high demand in the US, a condition that encourages offshoring.[44] According to the University of California, approximately 14 million white-collared American employees are susceptible to losing their current jobs because of offshoring.[45] In cases where companies have implemented offshoring to supplement their domestic employees' expertise and as an integral part of a broader growth strategy, the business practice has had little negative impact to home country levels of employment.[46]

Strategic Factors

The US Army War College's adaptation of Yarger's SAP, the Regional Strategic Assessment (RSA) Model, considers an examination of "social determinants of power", such as the Diplomatic, Informational, Military, and Economic aspects to be one approach toward examining strategic factors.[47] Yarger figures that many national interests overlap in their relevance to such instruments of power.[48] This is the case with offshoring; the practice appeals to the full range of strategic considerations.

From the diplomatic perspective, offshoring offers a valuable chit in promoting cooperation, an integral enabling component to tailored deterrence[49]. Cooperative nations are less likely to engage in hostile action toward each other. Even nations with wide ideological differences find peace when mutually beneficial trade relationships are at stake, such as the case with the US and China or the US and Saudi Arabia. In the latter example, the US has expanded its collaborative position past its obvious linkages to oil and on to an increasingly relevant security cooperation endeavor. The return on investment in cooperative ventures, such as offshoring, generally provides a measure of conflict prevention and a strong vote in favor of promoting the practice.

One common worry pertaining to the information element of national power, however, is the potentially disruptive role that offshoring may play in enabling breaches to system security. Some evidence indicates that offshoring may increase companies' exposure to operational risk. The Defense Security Service has discovered that some foreign bidders to US government contracts, for instance, submit their applications with the ulterior motive to obtain proprietary information.[50] The evidence is not entirely conclusive, however, that the practice of offshoring itself is fully to blame. The UK's Financial Services Authority (FSA) concluded that sensitive data shared with India's workers, for example, is not significantly more susceptible to information security risk.[51] The FSA study conceded, however, that operational risk will likely increase as firms expose more data to more offshore partners. A more accurate conclusion, then, may be that domestic firms engaged in offshoring must ensure that sufficient controls are in place to assure information security, given the nature of the data and reliability of participants in the transaction.

From a military standpoint, the US government participates directly in the practice of offshoring, with one notable example of a $35 billion Pentagon contract with a French company in 2008 to develop and supply new tanker aircraft.[52] Senator Murray (D) of Washington reacted, "We are hemorrhaging manufacturing jobs to foreign countries already, so I cannot imagine why ... our government would decide to take

44,000 American jobs, good jobs, and give them to the Europeans."[53] She continued her tirade to say, “Instead of securing the American economy and our military while we are at war, we are creating a European economic stimulus plan."[54] Her tonal message may be catering first to the near-term concerns of her jobless constituents. The crux of her complaint, however, is deeply reflective of the long-term strategic matter of losing control over America’s capability to sustain an innovative and responsive military capability. While offshoring certain menial functions intuitively presents only marginal military risk, exporting highly technical and other white-collar jobs exposes America to a much more significant risk of potentially degrading innovation and productivity.

Offshoring appeals to the economic domain primarily as a tool for individual companies or sectors to improve their productivity. Building alliances with foreign resource pools establishes greater access to skilled talent, a prerequisite for assuring cutting-edge innovative output. Because offshoring inspires shifts in domestic employment toward newer, higher paying industries, McKinsey Consulting researchers have determined that Americans collectively earn approximately 12-14 cents more for every dollar spent on outsourced foreign workers.[55] Another research group found that for every 1 dollar of foreign capital investment, American and foreign firms collectively spend an additional 1.5 dollars on domestic capital investment.[56] A reflection perhaps of the effects of comparative advantage, India registers a corresponding return of approximately 33 cents on each dollar spent by US firms outsourcing to India’s workers.[57] In effect, all things considered, offshoring benefits both countries from an economic standpoint.

In addition to identifying the topic's relationship to the instruments of power, Yarger suggests a reflective approach toward analyzing strategic factors in terms of causal relationships between change and future outcomes, in contrast to a practice of strict continuity.[58] With offshoring, the baseline situation consists of a relatively unregulated domestic access to foreign talent pools, introducing the opportunity to exchange services in the global marketplace. While all nations do not participate equally in the practice, the exchange generally promotes peaceful relationships and mutually economic benefits at the expense of displaced workers and potential breaches in proprietary knowledge. If the US were to refrain from offshoring, innovation would conceivably take longer to materialize, as the country would be limited in its access to affordable talent. If the US expanded its offshoring practice, it is likely that participants would experience an accelerated globalization of economies and interoperability.

The promotion of American values registers as a relevant strategic factor in the offshoring scenario. Specifically, offshoring engenders consistency in certain business practices among the participants. Foreign firms tend to adjust their business processes to more closely resemble that of American firms, making them more marketable as labor providers and proficient at delivering the desired level of service.[59] Offshoring may initiate opportunities to instill in trade partners such "Western" labor related concepts as equitable salary, equal treatment, and work ethic. Offshoring may also stimulate foreign interest in the English language and other aspects of the American culture, providing a labor differentiation in the global marketplace. These factors establish the practice of offshoring as a contributing agent for stability.

Key Strategic Factors

The “critical points of tension”, as Yarger refers to key strategic factors, represent the areas that America must effectively manage to fulfill or protect its core interests.[60] From this analysis, offshoring finds the predominance of its performance risk focused in its impact to the information and military determinants. Its risk in non-performance primarily lies in the diplomatic and economic context. In negotiating national strategy toward a more “favorable future”, the analysis of these factors will help the US to ultimately develop a strategic response that addresses them proactively so as to seize beneficial opportunities and to limit or mitigate negative outcomes.[61]

Strategic Response

The primary objectives for a strategy on offshoring should be to promote US economic prosperity, while preserving national security. These two end states are consistent with the country’s core values and represent the most significant strategic factors pertaining to offshoring. To accomplish these, the US should first incorporate the topic of offshoring into its routine distribution of strategic economic, military, and homeland defense policies. One way to develop and disseminate the policy would be through an annual National Strategy for Global Development document (NSGD)[62], put together in a similar manner as the National Military Strategy (NMS) and National Homeland Security Strategy (NHSS). The National Security Strategy (NSS) should inform the NSGD, just as it does with the other two, providing consistent and helpful guidance on matters like offshoring, immigration, corporate investments overseas, and global unemployment.

There could be a number of challenges in delivering this strategic response. One major disadvantage of establishing policy that promotes offshoring is the lack of public support. Displaced workers are not likely to cast enthusiastic votes for politicians who condone offshoring. To mitigate this risk, the President's message must clearly endorse the greater economic good, while introducing impactful domestic training and career re-tooling programs.

Another disadvantage is the long term potential for erosion of critical skills among the country's workforce. The strategy, therefore, should further establish controls to protect sensitive information and intellectual capital. For example, the NSGD could prescribe business governance rules that mandate encryption and establish thresholds to exposure of proprietary information. The controls should also include monitoring and reporting requirements to track compliance and provide the analytical basis for additional guidance.

The primary proponent for implementing the strategy should be the US Department of State. Diplomats would be required to craft strategic communication that facilitates the discovery and promotion of offshoring opportunities. They may also conduct reviews of best practices and monitor the degree of offshoring concentrations by country and industrial sector. Monitoring the portfolio of offshoring relationships should especially target transactions involving materials or services relevant to military power. Other implementers of the strategy would be the domestic and multinational corporations or municipalities engaged in offshoring. These participants should enjoy the free trade aspect of offshoring, while upholding core American values as inspirations to emerging countries.

Conclusion

In summary, offshoring represents an interest of important ramification to US national security. Although the practice commonly influences job losses in some sectors, offshoring generates offsetting job creation in other sectors and mutual economic benefit at the macro-economic level. It also provides a conduit for other forms of cooperation, as well as the spread of American values. As long as offshoring occurs alongside appropriate risk controls that encourage public support and guard against losses in intellectual capital, the resulting cooperation serves as an enabler for avoiding conflict, a strategically relevant concept for national security.

Endnotes

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